NO. 21119

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

SADIE KATZ,

Appellant,

vs.

UNITED STATES OF AMERICA, et al.,

Appellee.

APPELLANT'S REPLY BRIEF

APPEAL FROM
THE UNITED STATES DISTRICT COURT
FOR THE CENTRAL DISTRICT OF CALIFORNIA

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APPELLANT'S REPLY BRIEF

I

COMMUNITY PROPERTY LAW DOES NOT DICTATE NOR DIRECT THAT A TRANSMUTATION OCCURRED.

The Government's position that the necessary legal effect of the taxpayer's approval of the trust instrument was to part with her community interest in the property transferred to the trust is inaccurate in law and in fact. The Government mistakenly relies on three cases which have previously been analyzed in Appellant's Opening Brief. These cases are summarized as follows:

A. THE GOVERNMENT'S HEAVY RELIANCE ON THE METZGER, SCHINDLER, AND SPRECKELS CASES IS UNWARRANTED.

1. Metzger v. Vestal (1935), 2 Cal. 2d 517, 42 P. 2d 67.

In both the Metzger case and this case (hereinafter referred to as the Katz case, for clarity) the issue of consent by the wife to a transmutation is raised. Parenthetically, it is to be noted that Appellant approved rather than consented to the original trust instrument.

In the Metzger case the court specifically indicates that its decision is founded upon a determination that there was an underlying oral agreement to transmute between the spouses, a fact which the District Court found did not exist in the Katz case.

Another distinction between the Metzger case and the Katz case is that Metzger refers to personal property. The pages annexed to the trust declaration which is the subject of this dispute show that both real and personal property were made a part of the trust res. It is to be noted that there is a distinction between real property and personal property under the California community property system. This distinction is noted in those provisions of the code dealing with the husband's management and control of the community property, to wit, California Civil Code §172 and 172(a). The effect of Civil Code §172 is to restrict the husband's power to transfer community personalty. Civil Code §172(a) likewise restricts the husband's power to dispose of the community real property, but is to be even more strictly interpreted than the

personal property section because of the necessity that the wife must join in writing in any conveyance of real property.

A further distinction between the Katz case and the Metzger case is that Metzger discusses an improper gift. In conformity with this assertion, the Court in the Metzger case held:

> ". . . when the corporation was formed, it is contended, in substance, that there was an improper diversion or gift of community property without the written consent of the wife, Plaintiff's assignor. There is no merit in the contention." Metzger v. Vestal, supra, 42 P. 2d at page 69.

In the Metzger case certain assignees of the wife's creditors sought to set aside a transfer of community property from the husband to their son. The distinction to be made is that in the Katz case no attempt has been made by the Government to argue that Appellant had any intent to make a gift. It would follow that if Metzger is a case discussing when a wife or her creditors may set aside a gift of community property by the husband, it is far different in its legal effect from an alleged consent or approval to transmute community property to separate property.

2. Schindler v. Schindler (1954), 126 Cal. App. 2d 597, 272 P. 2d 566.

The Government apparently does not understand certain basic concepts of California community property law. Where property is community property, the wife retains a vested interest

therein. (California Civil Code Section 161(a)). Where the property is the husband's separate property, the wife has no interest therein. (California Civil Code Sections 157 and 163). The transmutation in the Schindler case is from the wife's separate property to community property. However, in the Katz case, the purported transmutation flows the other way and is allegedly from community property to the husband's separate property thus depriving the wife of her vested statutory interests therein. (California Civil Code Section 161(a)).

This factual distinction is so basic that any reliance on the Schindler case is non-persuasive.

3. Spreckels v. Spreckels (1916), 172 Cal. 775, 158 Pac. 537.

In the Katz case there is no issue of fact relating to a gift. California law, as is found in the Metzger case and in the Spreckels case, allows the wife to avoid a gift if she has not consented thereto or if there has been no consideration therefor. This position is entirely consistent with Appellant's position in the Katz case. But, the need to protect a wife by requiring either consideration for transfers by the husband of community property, or her consent thereto in the case of a gift, bears no factual application to the Katz case, because no intent to transfer by gift has been previously relied upon by the Government.

B. TAXPAYER DID NOT CONSENT TO THE DECLARATION OF TRUST.

As indicated in Appellant's Opening Brief, Appellant approved the declaration of trust; she did not consent thereto.

Appellant placed considerable emphasis in her Opening Brief on the powers of management of the community inherent in a husband pursuant to the California community property system. This argument is stated on pages 7, 8, 9, 10 and 11 of Appellant's Opening Brief. The point which Appellant sought to present was that Mrs. Katz had no alternative other than to go along with her husband's trust program. The Government has not seen fit to answer this argument.

Thus Appellant's position is that Mrs. Katz' "approval" of the trust instrument was only a reflection of her duty to acquiesce in her husband's management of the community. This acquiescence is illuminated by the use of the word "approval" rather than the word "consent".

C. APPELLANT DID NOT HAVE THE BENEFIT OF INDEPENDENT COUNSEL.

The trust instrument sets forth the fact that Appellant's deceased husband Leroy J. Katz was the Trustor, and that Mr. Fischgrund is the attorney for the Trustor.

Appellee asserts in its brief that Mr. Fischgrund was in

effect relied upon as the attorney for both the Trustor and Appellant.

Appellant's confidence or faith in Fischgrund at the time of the creation of the trust is no substitute for capable independent counsel. Her utilization of Fischgrund's services after Mr. Katz' death does not establish that she had independent legal counsel when the trust was created.

Appellant cited Gregory v. Gregory and Vai v. Bank of America, at pages 20 to 21 of her opening brief, as authority for the proposition that the wife must be represented by capable independent legal counsel. The Government's failure to reply to Appellant's citations of these cogent authorities suggests the Government's inability to effectively argue that Appellant had the benefit of capable independent counsel.

D. APPELLANT'S "CONSENTS" TO AMENDMENTS TO THE TRUST MANIFEST HER CONTINUING COMMUNITY INTEREST IN THE TRUST RES.

Appellant has advanced the argument that if Appellant's approval (the original trust instrument was approved by the wife although she consented to subsequent amendments) totally divested her of any rights in the trust res, then she would not have been requested on two subsequent occasions to sign consent to amendments to the trust instrument. It would only be consistent with the Government's position that once Mrs. Katz approved the original declaration of trust, she had no rights in the trust res. The

District Court found that the original declaration of trust acted as an instrument of transmutation from community property to the husband's separate property. In reaching its decision on the cross motions for summary judgment in favor of the Government, the District Court failed to take into consideration the obvious intent of Mr. and Mrs. Katz to deal with the trust res as community property as is necessarily reflected by the requirement that Mrs. Katz consent to amendments. If one adopts the Government's position these consents were unrequired because they were after the fact.

E. THAT THE DEPOSITION AFFIRMS RATHER THAN NEGATES THAT THE INTENT OF THE APPELLANT AND OF THE DECEASED WAS TO MAINTAIN THE TRUST RES AS COMMUNITY PROPERTY.

In 1916 Appellant married Leroy J. Katz (Dep. p. 4, lines 25-26). Forty-four years later, Mr. Katz died. Appellee concedes (for purposes of the motion for summary judgment) that the property contributed to the trust was community property.

In 1940 Appellant and decedent moved to California (Dep. p. 6, line 26; p. 7, line 1). There is no evidence before this Court to indicate anything but a record of domestic tranquility between Appellant and her husband.

Appellant relied upon her husband's business discretion. For example:

"Q. Did you both decide as to what investments to purchase?

"A. No, I had faith in my husband's judgment." (Dep. p. 14, lines 14-16).

Sometime in 1956, Appellant and her late husband attended meetings at Title Insurance and Trust Company concerning the creation of an inter vivos trust.

It is interesting to note that nothing of record in this case illustrates anything but complete reliance upon and confidence by Appellant in Mr. Katz's management of the community property affairs.

At these first meetings at Title Insurance and Trust Company, the character of the trust res was discussed:

"Q. Was there any discussion at these meetings as to what the character of the property was, that is, was it separate property or was it community property?

"A. It was community property. It was our property, my husband's and my own." (Dep. p. 15, lines 21-25).

"Q. Do you remember at these meetings whether or not the question was asked by the trust officer, is this separate property or community property?

"A. There would be no reason for him

asking it. He knew it was our property." (Dep. p. 15, line 26 to p. 16, line 4).

After the trust was established, Appellant and decedent continued to consider the trust as a community venture.

"Q. Now, after they were transferred to the trust, did Mr. Katz have anything in his name that remained outside of that trust?

"A. It was in our name. It wasn't in his name, whatever we had." (emphasis added) (Dep. p. 17, lines 2-6).

"Q. When you transferred this property into the trust, did you have any kind of an understanding as to (who) [sic] owned the property?

"A. It was our property." (emphasis added) (Dep. p. 18, lines 2-5).

II

TAX LAW DOES NOT DICTATE NOR DIRECT THAT A TRANSMUTATION HAS OCCURRED.

A. Kirkwood v. Bank of America (1954), 43 Cal. 2d 333, 273 P. 2d 532.

In the Kirkwood case, the California Supreme Court did say, ". . . she [the wife] succeeded to a new and different interest in the property subject to the trust upon giving her consent to the

inter vivos disposition breaking up the community status of the property transferred". The Court did not say that the community property transferred to the trust became the husband's separate property, and the Court also did not say the wife retained no community interest in the trust as opposed to the property transferred to the trust. The Kirkwood case is one involving the construction of Section 13554 of the California Revenue and Taxation Code, which is one of a series of code sections (Sections 13551 through 13556) dealing with the taxation of community property upon the death of a husband under different methods of transfer from a husband to his wife. It is not a section dealing with the taxation of separate property. Separate property is considered in Revenue and Taxation Code Section 13805.

Thus, if the California court had construed the trust in the Kirkwood case to create separate property out of what had formerly been community property it would have addressed itself to the taxation of separate property under Section 13805.

The federal estate tax does not vary with different methods by which community property is transferred between husband and wife.

The federal estate tax taxes those interests in property which the husband owned at the time of his death, rather than those interests which his wife received as a result of his death. If the Kirkwood case had concerned itself with the federal estate tax payable on the death of the husband rather than the inheritance tax, the conclusion by the California court that the wife retained a

community interest in the trust, as distinguished from the assets contributed to the trust, would require that one-half of the value of the trust corpus be excluded from the husband's gross estate.

The difference between an inheritance tax case such as Kirkwood and the Katz case is illustrated by the fact that the results in the Katz case turn on the rights of the spouses in the property up to and at the time of the husband's death, whereas in the inheritance tax case, as the Court in Kirkwood pointed out, there the tax problem did " . . . not concern the wife's interest in the community property before the transfer but rather the interest which she received on her husband's death by virtue of the transfer, to thich she gave her written consent." Id. at 339.

The Government argues (Brief, p. 17) that if the wife in Kirkwood retained a community interest in the rights and powers of the husband in the trust when she continued to hold a "present existing, and equal interest" in the trust estate until her husband's death and the Court was in error in rejecting her argument that she was entitled to exclude from the transfer an amount equal to one-half of the net value of the entire trust property because that amount already belonged to her as community property. While this is an inaccurate statement of the Kirkwood case, as hereinafter pointed out, it is an excellent statement of Appellant's case and under estate tax law requires a judgment in Appellant's favor. However, as regards the Kirkwood case, this statement is erroneous in at least two respects. First, the wife in Kirkwood did not have a "present, existing and equal

interest' in the trust estate until her husband's death because her community interest was based on the community property law of the State of California as it existed prior to 1927, and therefore, her interest in the trust was a "mere expectancy" until her husband's death. Lahaney v. Lahaney (1929), 208 Cal. 323, 281 Pac. 67; Spreckels v. Spreckels (1897), 116 Cal. 339, 48 Pac. 228; Stewart v. Stewart (1926), 199 Cal. 318, 249 Pac. 197. Second, the tax problem in Kirkwood did " . . . not concern the wife's interest in the community property before the transfer but rather the interest which she received on the husband's death by virtue of the transfer to which she gave a written consent." 43 Cal. 2d at 339, 273 P. 2d at 535.

B. Commissioner v. Chase Manhattan Bank, 259 F. 2d 231, (C. A. 5th) cert. denied, 359 U. S. 913.

In discussing the Chase Manhattan case, supra, (Appellee's Brief, pp. 22 through 27), the Government carries forward its mistaken analysis of Kirkwood as a basis for differentiating Kirkwood and Chase Manhattan and the Katz case. At page 27 of its brief, the Government restates its premise that the California court in Kirkwood determined that the trust became the separate property of the husband when the wife relinquished her interest in the community property "upon giving her consent to the inter vivos disposition breaking up the community status of the property transferred". However, as indicated above, the Kirkwood case concerns California inheritance tax on two alternative methods of

disposing of community property; it does not deal with inheritance tax on separate property. The government fails to realize in analyzing the Kirkwood case, that the Court there treats the rights and powers of the husband in the trust as being community rights and powers.

C. United States v. Stewart, 270 F. 2d 894 (C. A. 9th).

In the Stewart case, this Court indicated its appreciation of this difference, where at page 902 of the opinion it stated that the interests in one of the four matured annuity policies were community rather than separate property and that the wife's endorsement of the policy "did not in our opinion constitute a surrender of her interest in the policy" (Id. at p. 898).

In Stewart, this Court stated that, notwithstanding its hybrid nature, life insurance has not been regarded by the California courts as requiring it to be treated sui generis for purposes of California community property laws. The Government argues that the Stewart decision is not applicable unless the inter vivos trust "is an item of community property in the first instance" (Brief, page 27), and that the Kirkwood case held that such a trust is not community property. This line of reasoning is erroneous in that Kirkwood did not reach the conclusion the Government seeks to read into it; in fact it reached the opposite conclusion.

The Government, taxpayer and Amicus Curiae have been unable to find any case other than Kirkwood which deals with the nature of the interests created by the establishment of a revocable inter vivos trust of California community property. In the absence

of any authority requiring such interests to be treated differently from other types of community property, they should be treated the same as other types of community property. Such a result would be in accord with the public policy of the courts and in accord with the expectations of others situated similarly to the taxpayer.

To paraphrase Amicus Curiae in its analysis of the Chase Manhattan and Stewart cases, a differentiation should be made between the interests in the community as between the husband and wife, and as between the community and third parties. The result of the wife's approval in the Katz case, while binding upon the community in its relationship to third parties, does not and should not affect the interests of the husband and wife as members of the community. This position is supported by the holding of this Court in the Stewart case and in the case of Ettlinger v. Connecticut General Life Insurance Company (1949) (C. C. A. 9th), 175 F. 2d 870 in which this Court held that the wife's ratification of the beneficiary designation of an insurance policy by the husband is not intended to alter the community rights between her husband and herself during her husband's lifetime unless the contract specifically provides for such an alteration. In considering this question in the Stewart case, this Court said, " . . . in effect the joinder of the husband and wife in this settlement agreement constituted a transfer by the community under which the community retained for its life or the life of the survivor the right to income from the property".

Amicus Curiae (Brief, page 16) aptly argues by analogy

that nonfraudulent transfers by a Texas husband of community property and transfers by a California husband of community property with the wife's consent are essentially equivalent as relates to the interests between the husband and wife. That argument need not be repeated here.

The Government's argument in its Brief at pages 22 and 23 is that the wife's absence of knowledge in the Chase Manhattan case makes it clearly distinguishable from the Katz case. That argument is logically insufficient. Because of the difference in local community property law, the approval of Mrs. Katz was required to make the creation of the trust legally sufficient, where, as in this case, the trust corpus included real property. That approval in no way indicates that as between Mr. and Mrs. Katz there was any intent to change the community rights and duties of the husband and wife. In the Chase Manhattan case, the controlling question before the Court was whether or not there was a transmutation of the community property of the husband and wife into the separate property of the husband. At pages 236 and 244, the Court states this fact, and goes on to hold that there was no transmutation of the community property into the husband's separate property. That holding and the holding in the Stewart case, under the facts here involved, require the reversal of the trial court's judgment.

III

A. THE QUESTION OF THE VALIDITY OF THE TRUST INSTRUMENT IS PROPERLY BEFORE THE COURT AT THIS TIME.

The Court succinctly stated in the Chase Manhattan case, supra, at page 237, that while the Commissioner of Internal Revenue owed a duty to the United States of America to litigate zealously to collect taxes, he also owed a duty to all taxpayers to see that the law was applied justly and had, " . . . no vested right in an opponent's error, in the lower Court".

The purported ambiguity in the Trust, asserted by the Government on pages 30 and 31 of its Brief, is certainly subject to interpretations other than the one the Government has set forth. The second paragraph of Section Four, of the Trust, does not contradict the first paragraph. The Government asserts that the Trustee must have had the power to administer the trust. The Government argues that because the Trustee could not exercise any powers during the Trustor's lifetime without his written consent, by inference, the Trustee must then have had some powers to administer during the Trustor's lifetime. A more logical construction is that that paragraph is intended to reinforce the position that all of the powers of the administration of the Trust were reserved by the Trustor, and " . . . the Trustee shall have no rights, duties, or powers with respect to any property held under this trust . . ." (Paragraph 1, of Section 4 of Trust). The

Government's argument is therefore totally without foundation, and the Government fails to assert any convincing argument that the Trustee, Title Insurance and Trust Company, was anything other than the mere custodian of the legal title to the trust property.

Even if the Government's view is accepted, it only raises itself to the level of establishing the existence of an ambiguity in the trust instrument which, under any circumstances, would require a trial on the merits of this matter so that evidence could be introduced to resolve the ambiguity.

B. THE TRUST INSTRUMENT IS INVALID.

1. Reiss v. Reiss, 45 Cal. App. 2d 740, 114 P. 2d 718, cited by the Government, is clearly distinguishable from the Katz case in that the trust referred to in the Reiss case did not discuss the issue of the reservation of the power to control and administer the trust by the trustor as exists in the trust in the Katz case. Reiss only sets forth the principle that a trust will not be found invalid if the trustee is not required to exercise an active duty, but is only obligated to reconvey the property to the grantor upon demand, or to otherwise encumber it for the benefit of the grantor.

2. Hansen v. Bear Film Co., 28 Cal. 2d 154, 168 P. 2d 946, also cited by the Government, is distinguishable from the Katz case on the same grounds which distinguish the Reiss case from the Katz case.

3. Monell v. College of Physicians and Surgeons, 198 Cal. App. 2d 38, 17 Cal. Rptr. 744 cited by the Government does not significantly advance its position. The holding of the Court in the Monell case was that an agency was created rather than a trust, and therefore an invalid testamentary disposition resulted. Furthermore, a factual parallel between the Monell and the Katz cases cannot be drawn. Not only was an agency found in the Monell case but also the terms of the agent's authority were limited to paying certain medical bills, and then upon the death of the purported settlor, the remaining funds were to be turned over to a third person. Mr. Katz, however, reserved in total the right to deal with the property as he desired, and he was accountable to no other person. The purported Trustee had no power to deal with the property in any manner during Mr. Katz's lifetime, other than to be the mere custodian of the legal title to the purported trust property.

The California courts have not, so far as Appellant is able to ascertain, ruled on the approval or disapproval of Section 57 of the Restatement of Trusts (2d), American Law Institute. Therefore, the rules gleaned from De Martini v. Allegretti (1905), 146 Cal. 214, 79 Pac. 871 and Noble v. Learned (1908), 153 Cal. 245, 94 Pac. 1047, are the only expressions by the California courts on this issue, and they are consistent with the rule set forth in Newman v. Dore, 275 N. Y. 371, 9 N. E. 2d 966. The principle set forth in the Newman case is that a purported trust is invalid where a purported settlor reserves the power to amend or revoke

the trust, retains a beneficial life interest, and in addition, retains the power to control the Trustee in the administration of the trust. Mr. Katz's retention of the total power to deal with the trust property during his lifetime without the necessity of accounting to any other person creates the fatal defect rendering the Katz trust invalid.

IV

THE INTEREST OF APPELLANT IN THE TRUST PROPERTY IS NOT INCLUDABLE IN THE GROSS ESTATE OF LEROY J. KATZ UNDER SECTION 2041 OF THE INTERNAL REVENUE CODE.

Appellant contends that upon the transfer to the trust of the community property of Appellant and her deceased husband, her deceased husband held certain powers enumerated in the trust on behalf of the community and that his right to exercise these powers was coextensive with the powers given to a husband by statute to deal with the community property.

Appellant has argued in her opening brief, Section VII, pages 32, et seq. that the powers which the decedent held pursuant to the trust instrument were held by him as agent for the community and were powers belonging to the community and not to the decedent as his separate property. If that position is valid, then it follows that Section 2041 of the Internal Revenue Code is no more applicable to the question here presented than Sections 2036 and 2038.

If the estate is liable under Section 2041, it is also liable under Sections 2036 and 2038. The Government has failed to reply to Appellant's argument in this regard. In its brief (page 33) in arguing Section 2041, the Government is unable to cite any cases as authority for its position, or to distinguish the cases cited by Appellant. The only case referred to by the Government, and that for comparison's sake only, is Phinney v. Kay (5th Cir. 1960), 275 F. 2d 776, which is a case involving the possession of a general power of appointment by a surviving spouse over her deceased husband's interest in the community property as granted to her in their joint and mutual will. That case is not authority for the imposition of tax under Section 2041 in the Katz case, for the reason that it is factually totally unrelated to the Katz case. In Phinney, the husband predeceased the wife and upon her subsequent death a tax was assessed on both halves of the community property. The theory relied upon was that the rights granted to the wife in Texas community property under a joint and mutual will amounted to complete ownership.

More relevant to the question here involved are the cases cited by Appellant in her opening brief, at page 32 et seq. United States v. Goodyear; Lang v. Commissioner and Rickenberg v. Commissioner of Internal Revenue. That argument need not here be repeated. It is sufficient to say that under the holding in those cases and the Chase Manhattan case, if Mr. Katz had exercised his powers to alter, amend, or revoke the trust, he would have done so as agent for the community. Appellant contends that the

alteration or amendment of the trust would require the written consent of Mrs. Katz, a practice which the parties in fact followed in the case of both amendments made to the trust. Had Mr. Katz elected to revoke the trust, it would have resulted in the substitution of the trust res as a community asset in place of the community interest in the trust rights and powers.

CONCLUSION

After years of marriage, a trust is created of community assets.

The Appellant signed approval of the trust and subsequently consented to two amendments thereto.

The Government now argues that the very basic spirit of community property law is obviated because of the necessary legal effect of Appellant's approval.

In her opening brief, Appellant argued that if a domestic problem had developed between Appellant and her deceased husband, any California court would have found that the trust agreement did not effectively destroy Appellant's vested interests in the community property. BUT, that is exactly what the position of the District Court accomplishes.

It is interesting that Appellee remains silent on this point in its opening brief.

Equitably speaking, this appeal concerns itself with whether Appellant is foreclosed from showing that there was no intent on

her part (or on her husband's part) to divest herself of her statutory right to one-half of the community.

To effectuate such a transfer should require the clearest possible manifestations of intent. The deposition shows no such intent. Appellant was asked on two occasions to consent to trust amendments after she had already approved the trust. The only reasonable explanation for this is that the parties felt that notwithstanding her prior approval it was necessary for Mrs. Katz to continue to assent to any subsequent alterations or amendments.

These facts not only negate Appellee's position but underline the error of the District Court of not granting Appellant's Motion for Summary Judgment.

Respectfully submitted,
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CERTIFICATE

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

/s/ Burton S. Levinson
BURTON S. LEVINSON

APPENDIX "A"

CALIFORNIA CIVIL CODE

§157. SEPARATE PROPERTY; DWELLING

Neither husband nor wife has any interest in the property of the other, but neither can be excluded from the other's dwelling except that in actions or proceedings for divorce, annulment of marriage or separate maintenance, the court may make orders for temporary exclusion of either party from the family dwelling or from the dwelling of the other, until the final determination of the action.

§163. SEPARATE PROPERTY; HUSBAND

SEPARATE PROPERTY OF THE HUSBAND. All property owned by the husband, before marriage, and that acquired afterwards by gift, bequest, device or descent, with the rents, issues, and profits thereof, is his separate property.